CRAIG THOMAS
WYOMING

United States Senate

WASHINGTON, DC 20510-5003

July 9, 2003

Johnnie Burton
Director, Minerals Management Service
United States Department of Interior
1849 C Street, NW
Washington, D.C. 20420

Dear Johnnie:

Enclosed you will find a letter I received from Governor Dave Freudenthal expressing concerns regarding the federal royalty collection program.

I would appreciate a response to these concerns and any additional information you have on this matter. Please do not hesitate to contact Cindy Reed on my staff at 202-224-6441 for more information.

Sincerely,

Craig Thomas

Craig Thomas
United States Senator

CT:cr

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

SEP -5 2003

The Honorable Craig Thomas
United States Senate
Washington, D.C. 20510

Dear Senator Thomas:

Thank you for your letter dated July 9, 2003, regarding the Federal royalty collection program. I appreciate your providing me with the letter you received from Wyoming Governor Freudenthal regarding the proposed changes to the Federal oil and gas valuation rules. I certainly share his concern and yours about ensuring any change in these rules do not have a negative impact on Wyoming and the State's share of royalties.

As Governor Freudenthal indicated in his letter, this past spring MMS announced that it was holding several public workshops on both the Federal oil and gas valuation rules. Prior to announcing these workshops, we contacted staff from our Senate and House authorizing and appropriations committees to inform them of our plans and to offer them briefings. I was also very pleased to have had the opportunity to meet with some of the Western Governors, including Governor Freudenthal, to discuss our plans for seeking public input on these rules.

Like most Federal agencies, MMS continually evaluates the effectiveness and efficiency of its rules. Adding clarification and simplicity to the existing rules will reduce litigation, assure more contemporaneous compliance, reduce administrative costs to the Federal Government and lessees, and make Federal lands more attractive for development and leasing. We identified certain technical issues, both for crude oil and natural gas that we believe warrant consideration and public comment. Following is a brief summary of the issues we are considering and why, for each of the two rules:

<u>Federal Crude Oil Valuation Rule</u>

The MMS promulgated the current rule for valuing crude oil produced from Federal leases in June 2000. Our experience thus far has shown that the 2000 Federal oil valuation rule has ensured a fair return on Federal resources and generally served MMS, the states and the producing industry well. The technical issues we are considering concern primarily which published market prices are most appropriate to value crude oil not sold at arm's length and what transportation deductions we should allow. Through our experience in taking and selling royalty-in-kind (RIK) oil and information learned during litigation challenging the 2000 rule, we have identified certain items that would help to clarify the rule while maintaining the overall basic concepts and principles of the rule.

Federal Gas Valuation Rule

The rule for valuing natural gas produced from Federal leases has been in place since March 1988-over 15 years. However, in 1998 some amendments to this rule took place. In general, this rule seems to serve all stakeholders well, but our current review indicates minor changes may be needed.

At the workshops held this spring, we had excellent participation from the states, tribes, and the oil and gas industry. We were very pleased to have representatives from Wyoming participate in each of the workshops. Based on the input received, we decided to proceed with proposed rules seeking public comment for Federal oil and gas valuation. We published the proposed Federal oil valuation rule on August 20, 2003, and anticipate publishing the proposed Federal gas valuation rule this fall. Both rules will contain detailed analyses of the royalty impact to the states, the Federal Government, and the oil and gas industry. Comments on the proposed Federal oil valuation rule are due by September 19. We strongly encourage Wyoming to provide written comments on both of these rules.

Governor Freudenthal provided you with a number of specific comments for which I have provided a detailed response in the enclosure to this letter. If you would like to discuss any of these issues further, please do not hesitate to call me at (202) 208-3500.

Sincerely,

Johnnie Burton

R. M. "Johnnie" Burton
Director

Enclosure

Enclosure

Response to Governor Freudenthal's Specific Comments on the Federal Oil and Gas Valuation Rules

Transportation deductions

Governor Freudenthal:

1) "The current regulations under CFR §§206.110, 206.111, and CFR §§206.156, 206.157 already determine the allowable transportation cost deductions. The CFR adequately defines such cost and covers all necessary cost deductions. MMS should not allow any indirect deductions for transportation. Most of the deductions being discussed are relabeled marketing costs, and MMS has a long-standing policy of not allowing either direct or indirect marketing costs. There is no reason to change the detailed transportation allowances as currently set out."

Response:

The MMS does not intend to modify its long-standing policy of not allowing as a deduction from gross proceeds the costs of placing production in marketable condition or costs of marketing production including indirect, internal costs.

For the proposed Federal oil valuation rule, we are soliciting comments on providing a specific list of allowable and nonallowable transportation deductions, similar to what we did in the amendments to the gas transportation allowance rule in February 1998. Our intent is to promote greater clarity and simplicity for paying royalties. At the workshops we held on the Federal oil valuation rule, we heard general support from industry and state participants for providing a list of allowable and nonallowable transportation costs to help to clarify accounting methods and streamline audit procedures.

Rate of return

Governor Freudenthal:

(2) "The rate of return was a hard-fought compromise between industry and the MMS – in which the MMS prevailed. There is, again, no reason to change the current rate, add any factor or otherwise reopen this issue."

Response:

As you are probably aware, the producing industry filed a lawsuit challenging several of the provisions in the 2000 Federal oil valuation rule (Independent Petroleum Association of America v. Baca, Civil No. 00-761 (RCL) (D.D.C.), and American Petroleum Institute v. Baca, Civil No. 00-887 (RCL) (D.D.C.) (consolidated).) That lawsuit is still pending.

ely is preferable to the costs, delays, and uncertainty inherent in attempting to analyze appropriate project-specific or company-specific rates of return on investment. That is why at the public workshops, we requested public comment on possible multiples of the Standard and Poors BBB bond rate as a measure of the oil and gas pipeline industry's cost of capital. In the published rule, MMS is asking for comments on a rate of return of 1.5 times the Standard and Poor's BBB rate.

The potential for encouraging infrastructure development among pipelines and thereby increasing income to the states is also a consideration in our decision to reopen the discussion on this issue. We have estimated that for each one-tenth increase in the bond rate multiplier, there is a $750,000 decrease in royalties per year most of which is attributable to offshore royalties.

Affiliate downstream valuation

Governor Freudenthal:

(3) "We emphasized upfront that, if companies have affiliate sales which lead to an arms-length, downstream sale by their affiliate, the downstream sales price should remain the basis for royalty payments."

The technical changes that MMS is considering for the Federal oil valuation rule do not alter the basic structure or underlying principles of the June 2000 rule. Under that rule, a lessee producing from Federal leases in the Rocky Mountain Region that sells its production to an affiliate must elect for a 2-year period to pay royalties on either the affiliate's arm's-length resale price or one of four benchmarks. We are not proposing to change that aspect of the rule.

Under the current Federal gas valuation regulations, the value of gas not sold under an arm's-length contract is the first in a series of three benchmarks. At the same time, those regulations require that "under no circumstances" shall value be less than the "gross proceeds accruing to the lessee for lease production...." In *Texaco Exploration & Production Co.*, Docket No. MMS-92-0306-O&G (May 18, 1999), the Secretary interpreted the term "lessee" as including a wholly-owned or wholly-commonly-owned affiliate in circumstances of a transfer to the affiliate followed by an arm's-length resale.

However, on June 27, 2003, the D.C. District Court in a case involving Fina Oil and Chemical Company, held that this language does not include affiliates. The Court held that the term "gross proceeds accruing to the lessee" "refers only to proceeds accruing to Fina, not to the entire corporate family of which Fina is a member." We are currently evaluating the Fina decision and its impacts on our audit processes. We are involving the states with which we have cooperative audit agreements, including the Wyoming Department of Audit, in those discussions.

NYMEX and differentials

Governor Freudenthal:

(4) "NYMEX could be used for valuing all crude oil, where the use of an index is appropriate. Using the calendar month, rather than the trading month, would simplify its use. NYMEX is widely referenced by traders and representatives and is reflective of the market.

NYMEX is less susceptible to manipulation than price surveys, as we have seen recently in some well publicized cases. The sweet crudes of southwestern Wyoming frequently have a NYMEX plus differential. The demand of the Salt Lake City refineries have a positive influence on regional differential, such that the preference for southwestern sweet crude results in a selling price greater than NYMEX (i.e., NYMEX P+). In these situations, the differential will be positive. Differentials should only be allowed if they are reasonable and actually incurred – in other words, no theoretical costs, only actual reasonable cost."

Response:

For crude oil not sold at arm's length, the 2000 Federal oil rule provides for the use of spot prices at defined market centers published in approved publications as the basis for valuation of crude oil for most of the country except the Rocky Mountain Region. (In the Rocky Mountain Region, spot prices are the basis for the third "benchmark.") Our experience with the rule and comments we have received lead us to believe, like the Governor, that New York Mercantile Exchange (NYMEX) futures prices may represent a more reliable and better assessment of current oil values than spot prices. But making that change will require us to revise the 2000 Federal oil rule; the Governor seems to agree with the change we are proposing.

Under the 2000 rule, market center index prices are adjusted to determine the value of production at the lease through location and quality differentials and deduction of actual transportation costs.

Despite administrative history, MMS initially proposed to value the gas after the Bureau of Land Management's royalty measurement point.

There is not a market pipeline in the country that would accept gas at the wetness and pressure of the coalbed methane gas after the BLM's royalty measurement point. There would be no need for a processing plant if the market pipeline would accept the gas in the condition it is in before entering a processing facility. The costs associated with compressing the gas to market pipeline pressure, dehydrating it and removing the CO_2 *should not be deducted from the value used to calculate federal royalty.*

The consequence of selecting a valuation point other than the processing facility outlet would be disconnecting royalty determination from a practical touchstone. That could result in the loss of millions of dollars in federal royalty revenue – and, in turn, valuable services – for the people of Wyoming and the United States.

Response:

The Governor is referring to an issue involving the valuation of coalbed methane produced from the Powder River Basin in Wyoming. We have received input from the Wyoming Department of Audit in evaluating this issue. Our analysis is not yet complete. Please be assured that we have no intention of changing our long-standing policy requiring Federal oil and gas lessees to put gas into marketable condition and to pay royalty on the value of the gas in marketable condition. We will communicate our policy decision to states having coalbed methane production as soon as the decision is final.

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

JUN - 3 2003

Memorandum

To: Scheduler to the Secretary

Through: Rebecca W. Watson Rebecca W. Watson JUN - 4 2003
Assistant Secretary, Land and Minerals Management

From: R. M. "Johnnie" Burton
Director JBurton

Subject: Invitation - Visit High Tech/Reality Center

Request: Invite Secretary Norton to visit one of industry's high tech/reality centers. An example would be a visit to SEPCove (Shell Exploration and Production Cove.) One is located in New Orleans, Louisiana, and there are other companies and locations

Purpose: This is an opportunity to highlight technological advances in offshore exploration and production emphasizing safety and the protection of the environment. The event could be the stage for a discussion of the importance of offshore production in meeting the energy needs of the nation, and the tremendous advances that are being made in safety and environmental protection. The OCS provides more than 25 percent of our natural gas and 30 percent of the oil produced in the United States.

Background: The visualization center has become a powerful tool in decision-making during the initial phases of exploration, the drilling of wells, the placement of pipelines on the seafloor and design of platforms. Immersive visualization sessions are like an armchair journey to the center of the earth --- in 3D. The stereo glasses worn by participants transform screen displays of the earth's inner regions into 3D images. The seafloor, channels, canyons, and the subsurface salt masses and sedimentary layers are displayed in colorful detail. The images can be zoomed into, turned, viewed from above, sideways or even underneath. This ability to see into the earth's layers provides significant opportunities to more accurately determine the presence of oil and gas, to reduce risk in drilling and to plan pipeline routes that are environmentally acceptable. The SEPCove, using a different software, Plant Design Management System, allows the engineering group to design and walk though a production platform, allowing for quick identification of clashes and design challenges.

Date/Location: Date and location to be determined.

Contact: Nancy Messer, Chief of Staff to the Director, MMS, (202) 208-3500
Ed Shaw, Special Assistant to the Director, MMS, (202) 208-3500